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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1951

No. 693.

NAHUM BIRNBAUM, MORRIS J. LUTTERMAN and HANA D. LUTTERMAN, co-partners, doing business under the firm name and style of Birnbaum & Co., suing on their own behalf and on behalf of all similarly situated stockholders of NEWPORT STEEL CORPORATION, and on behalf of NEWPORT STEEL CORPORATION,

Plaintiffs-Petitioners,

—against—

NEWPORT STEEL CORPORATION, WILPORT COMPANY, C. RUSSELL FELDMANN,

Defendants-Respondents,

and

C. F. STAMM, et al.,

Defendants.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

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THE COURT PRESS, N. Y. C.

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IN THE

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Plaintiffs-Petitioners,

—against—

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and

C. F. STAMM, et al.,

Defendants.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Plaintiffs-Petitioners Nahum Birnbaum, Morris J. Lutterman, and Hana D. Lutterman respectfully pray the issuance of a writ of certiorari to the United States Court of Appeals for the Second Circuit to review a judgment and decision of that Court affirming an

order and judgment entered by the United States District Court for the Southern District of New York on May 28, 1951, which dismissed the complaint herein for failure to state a cause of action.

Jurisdiction.

The judgment of the Court of Appeals was entered on January 10, 1952. The jurisdiction of this Court is invoked under Title 28 United States Code, Section 1254, 62 Stat. 928, and Section 27 of the Securities Exchange Act of 1934, Title 15 United States Code, Section 78aa, 48 Stat. 902, as amended.

Opinions Below.

The opinion of the District Court (Kaufman, S. H., *Dt. J.*) is reported in 98 Fed. Supp. 506. The opinion of the Court of Appeals for the Second Circuit (Swan, L. Hand, and A. N. Hand, *Ct. JJ.*) is reported at 193 F. 2d 461.

Questions Presented.

1. Do §10 (b) of the Securities Exchange Act and Rule X-10B-5 of the Securities and Exchange Commission grant protection to investors defrauded in connection with a purchase or sale of securities even though they are not themselves purchasers or sellers?

2. Do §10 (b) and Rule X-10B-5 govern fraud upon minority stockholders perpetrated by a fiduciary who breaches his duty in connection with the sale of his controlling shares of stock?

Statute and Rule Involved.

Section 10 (b) of the Securities Exchange Act (15 U. S. C. §78j (b) 48 Stat. 891) provides:

> "SEC. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * *
>
> "(b) To use or employ, in connection with the purchase or sale, of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule X-10B-5 of the Securities and Exchange Commission (17 Code Fed. Regs. §240.10b-5) provides:

> "Rule X-10B-5. Employment of Manipulative and Deceptive Devices.
>
> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange—
>
> "(1) To employ any device, scheme, or artifice to defraud;
>
> "(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements

made, in the light of the circumstances under which they were made, not misleading; or

"(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Summary Statement of Matter Involved.

Plaintiffs are minority stockholders of defendant Newport Steel Corporation ("Newport" hereafter), and sue to recover for Newport and all its stockholders $4,000,000 in illegal profits made by defendant Feldmann through the device of a sale of his controlling Newport stock.

The allegations of the complaint dismissed below are as follows:

One Feldmann was President and Chairman of the Board of Directors of Newport and owned or controlled 400,000 shares, or 40%, of Newport's outstanding stock. He thereby dominated and controlled Newport and its Board of Directors (R. 5). The remaining outstanding stock of Newport is held in numerous small holdings by several thousand stockholders widely scattered in residence (R. 5). An over-the-counter market for the stock existed, at prices of approximately $9 to $11 per share.

In August 1950, Follansbee Steel Corporation made a firm offer for a merger of Newport with Follansbee on terms highly profitable to all stockholders of New-

port (R. 5). Feldman concealed this offer and in letters to the shareholders misrepresented the nature of the negotiations with Follansbee (R. 20-21). Feldmann then rejected the Follansbee offer for the purpose of taking advantage of an opportunity to make an even greater personal profit by selling his own shares without benefiting the other stockholders of Newport (R. 5-7).

Feldmann's scheme was to sell, not the assets of Newport since then all the stockholders would share in the proceeds, but his own personal shares for the sum of $8,000,000—about $22 per share, or more than twice the market value of the stock (R. 8-9). Wilport Company, the purchaser, obtained control of Newport and its assets by buying Feldmann's 40%. On August 31, 1950, the date of Feldmann's sale of his stock to Wilport, Feldmann and his entire Board of Directors resigned from Newport, and Wilport named its own Board of Directors to manage and control Newport (R. 10, 22-23).

Wilport is a Delaware corporation, organized in August, 1950, for the sole purpose of purchasing the Newport stock. It is the "dummy" creature of approximately ten manufacturing companies which were willing to pay high, in a period of steel shortages, for the steady supply of steel for their manufacturing operations which they would divert from the regular customers of Newport (R. 8). As Feldmann knew, Wilport and its components paid him at least $4,000,000 more than the fair market price of his stock in order to gain control of Newport, and change its course of business to that of a captive supplier whose sole function would be to satisfy the needs of Wilport and its components in a steel-scarce period.

The effect was, in part, to destroy Newport's goodwill in the trade and its opportunity to develop long-range contracts which would insure its future (R. 11-12).

The rejection of the Follansbee offer and the sale by Feldmann to Wilport were effected without notice to the stockholders of Newport and by false and misleading statements sent through the mails to the Newport shareholders by the various defendants herein (R. 9-10, 13-14, 20-27).

The courts below have held that although a fraudulent scheme was alleged, §10 (b) and Rule X-10B-5 extend protection only to investors who stand in the position of parties to a sale transaction as purchasers or sellers of securities, and that plaintiffs and Newport, members of the public and investors, are not protected by §10 (b) and Rule X-10B-5, even though a sale of securities by their fiduciary was the means of perpetrating a fraud upon them. The holding of the Court was that §10 (b) has "no relation to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers" (R. 72; 193 F. 2d at p. 463).

Specification of Errors to Be Urged.

The Court below erred in

(1) Interpreting §10 (b) and Rule X-10B-5 so as to require proof of privity between plaintiffs and defendants, and thus to give no protection to the public and investors.

(2) Deciding that §10 (b) and Rule X-10B-5 do not apply to fraud practiced by a corporate fiduciary

upon his minority stockholders in connection with a sale of his securities.

Reasons Relied on for Allowance of the Writ.

1. This Second Circuit decision is in direct conflict with a decision of a District Court in the Third Circuit, *McManus* v. *Jessup & Moore Paper Co.*, Civil No. 8015 (D. C. E. D. Pa. 1948). The square conflict between the two cases is noted in Loss, *Securities Regulations* (Little, Brown & Co., 1st Ed., 1952), Chap. XI, p. 841; note 104.

2. The Court below has decided an important question of federal law which has not been, but should be, settled by this Court. The decision construes §10 (b) of the Securities Exchange Act, and not merely Rule X-10B-5. The words of the Rule, "in connection with the purchase or sale of any security", are copied directly from §10 (b), and the operative words are those of Congress. This novel case is the only one where, to our knowledge, a court has limited a section of the Securities Exchange Act so as to make impossible under that statute the promulgation of rules in the interest of the public and investors. It does not merely deny private rights. It construes the statute so that neither investors nor the S. E. C. may enjoin or otherwise seek relief against such frauds.

3. The Court below, in narrowly examining §10 (b) to discover limitations, adopted an approach hostile to the very purposes of the Act. The Securities Act of 1933 (15 U. S. C. §77 *et seq.*), the Securities Exchange Act of 1934 (15 U. S. C. §78 *et seq.*), and the Public Utilities Holding Company Act of

1935 (15 U. S. C. §79 *et seq.*) are all broadly remedial and should be read to effectuate their purpose of protecting investors. In *Kardon* v. *National Gypsum Co.*, 69 Fed. Supp. 512 (D. C. E. D. Pa. 1946), and *Fischman* v. *Raytheon Manufacturing Co.*, 188 F. 2d 783 (2d Cir. 1951), this approach was understood and used by Judges Kirkpatrick and Frank, and in *S. E. C.* v. *W. J. Howey Co.*, 328 U. S. 293, 301 (1946), this Court stated, with regard to the Securities Act of 1933: "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." Indeed, it was for the purpose of effectuating the provisions of the Act that the *Kardon* and *Fischman* and other lower court cases have consistently held that §10 (b) and Rule X-10B-5 provide for private rights of action for any victim of a fraud in connection with the purchase or sale of securities, although the statute does not specifically provide for such rights.

Section 10 (b) is a fraud provision of the Securities Exchange Act, to be invoked only where there is a scheme to defraud. It is not a burden on legitimate businesses; it is not a provision governing the financial responsibility of a broker, or requiring the filing of information with the Commission, areas where a strict construction may be proper.

Even before the passage of the securities statutes, it was recognized that fraud statutes must not be narrowly construed. *People* v. *Federated Radio Corp.*, 244 N. Y. 33, 154 N. E. 655 (1926); *Smith* v. *Whiteaker*, 118 Ore. 656, 247 Pac. 1077 (1926); *cf. Deaver* v. *U. S.*, 155 F. 2d 740 (C. A. D. C. 1946), cert. den. 329 U. S. 766. In *People* v. *Federated Radio Corp.*, *supra*, the Court stated (244 N. Y. at p. 48, 154 N. E.

at p. 657) that "The words 'fraud' and 'fraudulent practice' in this connection should, therefore, be given a wide meaning so as to include all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law."

Section 10 (b) of the Securities Exchange Act is necessary to the statutory scheme precisely because fraudulent practices and techniques are unpredictable, changing always in an effort to escape the law. For the lower court to rule that the kind of fraud against investors which is the subject of this suit was of no concern to Congress in this Act is certainly not the proper way to construe a protective statute. *S. E. C.* v. *W. J. Howey Co., supra; S. E. C.* v. *C. M. Joiner Leasing Corp.,* 320 U. S. 344 (1943); *Smolowe* v. *Delendo Corp.,* 136 F. 2d 231, cert. den. 320 U. S. 751 (1943).[1] Clearly, if broad procedural remedies are to be afforded the litigant in order to effectuate the purposes of the statute, *Deckert* v. *Independence Shares Corp.,* 311 U. S. 282 (1940), it is inconsistent

[1] Unconscionable breach of fiduciary responsibilities by corporate fiduciaries, including officers, directors, and controlling stockholders, was intended by Congress to be within the reach of §10 (b) and the Rules adopted thereunder. This view is supported by the legislative reports on the bills later enacted into law. The House Committee Report (H. Rep. No. 1383, 73d Cong., 2d Sess. (1934), pp. 5, 6, 13), emphasized that the Securities Exchange Act must extend the legal conception of a fiduciary relationship in order to protect the dependent position of the ordinary citizen. Corporate managers must be brought to a clearer recognition of their responsibilities as trustees of their corporations and the other stockholders. The Senate Committee Report (S. Rep. No. 792, 73d Cong., 2d Sess. (1934), p. 55) demonstrates the keen concern felt because of the flagrant betrayal of their fiduciary duties by directors and the intention of the Committee to put an end to such behavior.

to deny broad construction of the substantive rights which the statute is intended to enforce.

4. The decision below has established the requirement that a defrauded plaintiff must prove "privity" between himself and the defendant in a contract of sale in order to sustain a cause of action under the Act. It is perfectly clear that §10 (b), drawn as broadly as possible, was meant as a "catch-all" provision to provide against "all manipulative or deceptive methods" in connection with securities transactions. *Kardon* v. *National Gypsum Co.*, 69 Fed. Supp. 512, 514 (D. C. E. D. Pa. 1946).

It was this very requirement of privity, necessary for an action in common law fraud and deceit, which the various securities acts and regulations were designed to avoid.[2] The language of §10 (b) of the Act—"*in connection with* the purchase or sale of any security"—demonstrates the purposeful attempt of Congress to free a defrauded investor from the harshness of the "privity" doctrine, and to deal with fraud as broadly as possible. Yet, the Court below has held that this language binds the Commission and the public by the privity rule so that protection against fraud cannot be extended beyond the immediate parties to the fraudulent securities transaction.

The complaint herein alleges all the necessary elements of an action under §10 (b) and Rule X-10B-5. The defendants, through means of interstate commerce, have employed a fraudulent scheme and course

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[2] Examples of the attempts to free investors from the need to prove "privity" are §11 of the Securities Act of 1933 (15 U. S. C. §77k), §9 (e) of the Securities Exchange Act of 1934 (15 U. S. C. §78i (e)), and §18 of the Securities Exchange Act of 1934 (15 U. S. C. §78r).

of business which operated as a fraud upon plaintiffs and Newport, in connection with the purchase or sale of a security. Where, as here, the fraud complained of is effectuated by the sale of securities, and the seller is a fiduciary to those defrauded, protection under §10 (b) and Rule X-10B-5 should be extended. Section 10 (b) should not be judicially amended to apply only to the immediate parties to the purchase or sale.

5. The complaint herein did not seize upon the sale transaction from Feldmann to Wilport as something unconnected with the fraud; the sale itself was the instrument of the fraud and was the technique which resulted in the damage to Newport and its stockholders. Indeed, plaintiffs and Newport were parties to the sale transaction, for it was their property, control of the corporation and the value of its position in the steel industry, that was the subject of the sale. The lower court's decision limiting a cause of action under the Act to parties to a contract of sale only, is thus seen to be highly technical and not in accord with the expressed statutory intent of granting protection to the public and investors.

6. The decision of the Court below opens a great loophole through which corporate fiduciaries may defraud their minority stockholders. Even if the common law were to provide adequate substantive remedies in a situation such as this, the jurisdictional problems which the Act was meant to avoid are insuperable in a state court action. The securities statutes, with their provisions for nation-wide service of process, were intended to protect scattered security holders who could not protect themselves because of the inadequacies of state court jurisdiction. This case is

exactly the situation which the statute was meant to cure. The defendants herein are residents of states from Maine to California (R. 38-40). Newport is an Indiana corporation allegedly not presently doing business in New York (R. 4, 35-38). Wilport is a Delaware corporation (R. 4). Feldmann lives in New York (R. 4). The other stockholders are scattered all over the country, and an over-the-counter market exists in Newport's shares (R. 5). It would be impossible to bring all necessary parties before a court and to obtain full determination of the allegations of the complaint, except pursuant to the statutory provisions of §27 of the Securities Exchange Act, which provide for nation-wide service of process.

No such gap in the area of regulation was intended to exist by Congress. It is for this reason that §10 (b) was phrased as a "catch-all" provision intended to grant protection to the public and investors against all types of fraud. Neither §10 (b) nor Rule X-10B-5 should be bound by the strict construction given them by the Court below. *S. E. C.* v. *C. M. Joiner Leasing Corp., supra; Smolowe* v. *Delendo Corp., supra.*

7. Before the broadly remedial purpose of Congress to grant protection to the public and investors against all types of fraud is limited in accordance with the decision below, this Court should rule on the question. The issue herein is one of great public importance, since it will determine whether investors have any effective remedy against fraud by a fiduciary in connection with a purchase or sale of securities.

Conclusion.

Petitioners pray that a writ of certiorari issue to the United States Court of Appeals for the Second Circuit commanding said court to certify and send to this Court a transcript of the Record in this cause to the end that the same may be here reviewed and determined; that the judgment and decision of said Court of Appeals be reversed; and that Petitioners have such other relief as may be proper.

April 1952.

NAHUM BIRNBAUM, MORRIS J. LUTTERMAN
and HANA D. LUTTERMAN,
Petitioners,
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IRVING CONSTANT,
Of Counsel.

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—and—

C. F. STAMM, ET AL.,

Defendants.

BRIEF OF RESPONDENT C. RUSSELL FELDMANN IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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I.

Opinions Below.

The opinion of the District Court is reported at 98 F. Supp. 506. The opinion of the Court of Appeals is reported at 193 F. 2d 461.

II.

Jurisdiction.

The jurisdiction of this Court is invoked under 28 U. S. C. § 1254 and 15 U. S. C. § 78aa (Securities Exchange Act of 1934, Section 27).

III.

Statute and Rule Involved.

Section 10(b) of the Securities Exchange Act (15 U. S. C. § 78j(b), 48 Stat. 891) provides:

> "Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule X-10B-5 of the Securities and Exchange Commission reads:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> "(1) to employ any device, scheme, or artifice to defraud,
>
> "(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of

the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

IV.

Counter-Statement of Matter Involved.

The complaint was dismissed below for failure to state a claim upon which relief can be granted. Jurisdiction was invoked solely under Section 10(b) of the Securities Exchange Act of 1934 and Rule X-10B-5, *supra*.

Neither the plaintiffs nor Newport Steel Corporation bought or sold any securities. The Courts below, holding that Section 10(b) and Rule X-10B-5 were directed against frauds upon purchasers and sellers of securities, dismissed the complaint for failure to state a claim under that Act. Jurisdiction was not otherwise claimed.

The complaint alleges that respondent Feldmann sold to respondent Wilport Company approximately 40% of the stock of Newport Steel Corporation (not listed on any securities exchange), and thereupon the old board of directors resigned and were replaced by nominees of the new stockholder. Neither the seller (Feldmann) nor the purchaser (Wilport Company) was defrauded by the other in the sale.

Petitioners state (Petition, p. 5) that Feldmann concealed from the other stockholders an offer of Follansbee Steel Corporation to merge with Newport Steel Corporation, misrepresented the nature of the negotiations in a letter to stockholders, and then rejected the offer so that he could make the above-described sale of the stock to Wilport Company. They further state that Wilport Company intended to use Newport Steel Corporation as a "captive supplier" of steel to the Wilport Company stockholders.

Petitioners state (Petition, p. 6) that the Courts below held that a fraudulent scheme was alleged. The opinions of the Court may be read in vain for such a statement. The opinion of the District Court stated merely:

> "Even if it be assumed, without deciding, that the complaint alleges facts which amount to a fraud * * *." (Record, fol. 182)

It is only by an unsupported charge of a connection between the sale of the stock by Feldmann to Wilport, and certain letters to the stockholders, that petitioners attempt to satisfy the preliminary requirement that any alleged fraud or deceit be effected by use of the mails. (Clearly, there was no use of any other means or instrumentality of interstate commerce, or of any facility of a national securities exchange.)

However, petitioners' statement (Petition, p. 6) that the sale of stock by Feldmann to Wilport Company was effected "by false and misleading statements sent through the mails to the Newport shareholders by the various defendants herein," is belied by the immediately preceding statement that such sale was effected *without* notice to the stockholders.

Petitioners' statement (Petition, p. 6) that the rejection of the Follansbee offer was effected by false and misleading statements to the stockholders, is likewise belied by the immediately preceding statement that the rejection was effected *without* notice to the stockholders.

Finally, petitioners do not claim that they took, or refrained from taking, any action as a result of respondents' conduct.

V.

Argument.

(A) No important question is involved.

The Court below held that Rule X-10B-5 was directed solely at frauds on purchasers or sellers of securities, and was not addressed to breaches of duty by corporate fiduciaries which might constitute a common law fraud upon the

corporation or its other stockholders, who were not purchasers or sellers.

Section 10(b) of the Securities Exchange Act is not self-operative, but merely permits the Securities and Exchange Commission to adopt rules thereunder. It is the violation of the Rule which constitutes the crime. No question arises here under Section 10(b); the only question is the interpretation of Rule X-10B-5.

The Securities and Exchange Commission reads its own Rule in the same way as it has been interpreted by the Courts below. It does not claim the added jurisdiction which plaintiffs would foist upon it, and did not intervene to urge a different result.

Petitioners assert that they bring to this Court the question of the construction of Section 10(b) (Petition, p. 7). This presupposes that Rule X-10B-5 makes unlawful all common law breaches of duty by corporate fiduciaries. However, as we shall show, and as the Courts below held, Rule X-10B-5 does not have the broad purpose petitioners ascribe to it. The Commission has made no rule which covers the case at bar, and the question of the scope of Section 10(b) therefore does not arise.

(B) The decision below does not conflict with a decision of another Court of Appeals.

Petitioners do not bring themselves within Rule 38, subd. 5(b), even if the decision of the Court below were in conflict with the decision in *McManus* v. *Jessup & Moore Paper Co.*, Civil No. 8015, in the District Court for the Eastern District of Pennsylvania. The *McManus* case, which was merely a denial of a motion to dismiss without opinion, was not a decision of another Court of Appeals.

A conflict between decisions of a Court of Appeals and of a District Court in another Circuit is not such a conflict as will move this Court to grant certiorari (Robertson & Kirkham, *Jurisdiction of the Supreme Court of the United States*, 1951 Ed., § 325).

Further, the *McManus* case, being without opinion, is not in conflict with the decision below; it is impossible to ascertain from the court records whether jurisdiction was found to exist under the Securities Exchange Act or under the Bankruptcy Act, under which jurisdiction was also invoked.

(C) Interpretation of Rule X-10B-5 by the Securities and Exchange Commission.

When Rule X-10B-5 was promulgated, it was accompanied by Release No. 3230 of May 21, 1942, which explained the purpose and scope of the Rule as follows:

> "The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. *The new rule* closes a loophole in the protections against fraud administered by the Commission by *prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.* The text of the Commission's action follows:" (Italics supplied.)

Subsequently, when asked for an interpretation of the Rule, the Securities and Exchange Commission in Release No. 3634 of December 22, 1944 reiterated:

> "* * * Generally speaking, this Rule embodies the broad anti-fraud provisions of Section 17(a) of the Securities Act of 1933 but specifically prohibits fraud not only in connection with the sale of securities but also in connection with the purchase of securities." *

The administrative interpretation of the rule by the Securities and Exchange Commission makes the purpose and scope of the rule clear.

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* Section 17(a) of the Securities Act of 1933 (15 U. S. C. § 77q(a), 48 Stat. 84) applies only to a fraud or deceit "*upon the purchaser*" of securities. It reads in pertinent part: ". . . It shall be unlawful for any person in the sale of any securities . . . to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

The purpose of Rule X-10B-5 is to fill a gap in the Commission's power over fraudulent transactions in securities. Section 17(a) of the 1933 Act (15 U. S. C. § 77q(a), 48 Stat. 84) prohibits fraudulent practices in the *sale* of securities where use is made of the mails or interstate commerce is involved. Rule X-15C1-2, promulgated by the Commission under Section 15(c)(1) of the 1934 Act (15 U. S. C. § 78o(c)(1), 48 Stat. 895, as amended by 49 Stat. 1377 and 52 Stat. 1075), contains similar provisions applicable to registered brokers or dealers, with respect to either purchases or sales. Neither of these provisions prohibited fraud by others than broker-dealers in the *purchase* of securities. The Commission's answer to this loophole was the promulgation of Rule X-10B-5, which is expressly applicable to purchases or sales by any person. See Note, 59 Harv. L. Rev. 769, 770 (1946).

(D) Petitioners' contentions are without merit.

We submit that Rule X-10B-5 is clearly addressed to market manipulations and frauds upon purchasers and sellers of securities, and that the Commission did not intend to supersede existing civil procedures for the prosecution of actions against corporate fiduciaries for alleged breaches of their common law duties, when the party allegedly injured was neither a purchaser or seller of securities.

The opinions of the Courts below amply prove that proposition.

VI.

The Writ Should Be Denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1951

No. 693

NAHUM BIRNBAUM, MORRIS J. LUTTERMAN and HANA D. LUTTERMAN, co-partners, doing business under the firm name and style of Birnbaum & Co., suing on their own behalf and on behalf of all similarly situated stockholders of NEWPORT STEEL CORPORATION, and on behalf of NEWPORT STEEL CORPORATION,

Plaintiffs-Petitioners,

against

NEWPORT STEEL CORPORATION, WILPORT COMPANY, C. RUSSELL FELDMANN,

Defendants-Respondents,

and

C. F. STAMM, *et al.*,

Defendants.

BRIEF FOR RESPONDENT WILPORT COMPANY IN OPPOSITION

Opinions Below

The opinions below are reported at 98 F. Supp. 506 (S. D. N. Y. 1951, S. H. Kaufman, D. J.) and 193 F. 2d 461 (C. A. 2d Cir. Swan, Ch. J., L. Hand and A. N. Hand, Ct. JJ., opinion by A. N. Hand).

Jurisdiction of the Court

The jurisdiction of this Court is invoked under 28 U. S. C. § 1254 (1),* as amended.

Statute and Rule Involved

Section 10(b) of the Securities Exchange Act (15 U. S. C. § 78j (b); 48 Stat. 891) provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • • • •
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. (June 6, 1934, ch. 404, § 10, 48 Stat. 891.)"

Rule X-10B-5 of the Securities and Exchange Commission (17 CFR § 240.10b-5, 13 F. R. 8183) provided, as of the date of the actions alleged in this complaint:

> "*Employment of manipulative and deceptive devices by any purchaser of a security.* It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud.
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in

* Petitioners cite also 15 U. S. C. § 78aa, but that section relates to the jurisdiction of the federal courts of first instance.

order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Questions Presented

1. The ultimate question here is whether the complaint states a cause of action maintainable in a federal court. Since diversity of citizenship is not even asserted, that question depends in turn on whether the complaint alleged a cause of action arising out of a violation of Rule X-10B-5 of the Securities and Exchange Commission, issued under authority of § 10(b) of the Securities Exchange Act.

2. The question presented as to the proper interpretation of Rule X-10B-5 of the SEC is:

(a) Whether that Rule is directed against fraud upon the purchaser or seller in connection with his purchase or sale of securities, or whether the Rule extends to a broad field of breaches of the fiduciary duties owed by controlling stockholders and officers to other stockholders; and

(b) Specifically, whether the Rule applies for the benefit of minority stockholders whose grievance relates not to their own purchase or sale of stock, but to the rejection of an offer for merger of the corporation and a sale of his own stock by the controlling stockholder to third persons.

Statement

The defendants' motions (R. 30-32, 34), granted below (R. 63-64, 77), tested the sufficiency of the complaint to support federal jurisdiction.

With the correction set out beneath, petitioners' summary of the allegations of the complaint (Petition, pp. 4-6) appears to be adequate for present purposes. (A better summary, however, is that of the Court of Appeals, R. 70-72.)

In the next-to-last paragraph of their statement (Petition, p. 6), petitioners assert that the rejection of an offer for merger of Newport Steel Corporation, and a sale of the controlling stockholder's shares, were "effected * * * by false and misleading statements sent through the mails to the Newport shareholders * * *." On the contrary, the complaint shows that these communications played no part in effecting either the rejection or the sale complained of. (See R. 9-10, 13-14, 20-27.) Both the rejection and the sale involved third persons, not purchases or sales by the complaining minority stockholders (R. 8), and the communications in each instance related to what had already happened. (See R. 20-24, 26-27.)

In addition, petitioners' statement (p. 6) of the holdings of the courts below is, we think, likely to be misleading. It suggests that the courts below decided that the allegations of fraud were adequate to meet the requirements of Rule X-10B-5, except for the sole difficulty that plaintiffs were neither purchasers nor sellers. On the contrary, the district court made clear that it was not passing on the adequacy of the complaint as alleging fraud, saying: "Even if it be assumed, without deciding, that the complaint alleges facts which amount to a fraud upon the minority stockholders of Newport, plaintiffs may not have their remedy in this court, * * *." (R. 61.) The court then proceeded to base its decision on its construction of SEC Rule X-10B-5 as not intended to cover claimed wrongs of minority stockholders arising out of something other than their purchases or sales of stock (R. 61-62). The Court of Appeals expressed itself as "in accord with the district court's interpretation of the Rule" (R. 72) in this respect, without discussing the adequacy of the allegations as showing fraud or a scheme to defraud within the requirements of the Rule. The area of law to which

the complaint relates is the area of the obligation of controlling stockholders and officers (a) as to utilization of corporate opportunities or (b) in the sale of their control to outsiders. The only question passed upon by the courts below was the question of the extent to which Rule X-10B-5 applied to that area in a situation where the complaining stockholders had neither bought nor sold stock as a result of the actions complained of. The conclusion of all four judges was that the machinery designed for control of security-markets manipulation and frauds on purchasers and sellers of securities was not intended to be extended to stockholder suits of that type.

Argument

1. *There is no conflict among the Courts of Appeals.* The decision below was the unanimous decision of the Court of Appeals for the Second Circuit, Judges L. Hand, A. N. Hand and Swan sitting. It affirmed the judgment of the district court. No other Court of Appeals than that for the Second Circuit has been found to have passed on the point here involved. In their effort to show conflict, petitioners have been able to cite as against this unanimous decision of one of the foremost Courts of Appeals only a single unreported decision of a district court—*McManus* v. *Jessup & Moore Paper Co.*, Civil No. 8015, (D. C. E. D. Pa. 1948), in which no opinion was written. The complaint there alleged that plaintiff also invoked "the ancillary jurisdiction of this court with respect to matters and proceedings in bankruptcy" (Complaint, par. 1(d)). Plaintiffs' brief stated that "Relief was sought against a threatened violation of a plan of reorganization approved by this court under Section 77B of the Bankrupcty Act * * *." (Plaintiffs' Brief, p. 3.) Therefore the basis of even that single case is uncertain. Clearly it provides no adequate basis for an assertion of conflict among the Circuits.

2. *There is no important question of federal law which needs to be settled by this Court.* The question involved in this case relates primarily to the interpretation of an

administrative rule: Rule X-10B-5 of the Securities and Exchange Commission.

It is true that the Rule interpreted uses some of the language of the statute which gave the agency its rule-making power. However, the courts below, in interpreting the language as they did, relied in large part on the agency's own statements of purpose and its general scheme of control. (R. 61-62, 74.) If under the present statutory language the administrative rule had explicitly covered the situation here involved or expressly provided what petitioners contend, then the matter of the statutory coverage would be in issue. That is not the present case. The construction by this Court of the statute may well wait until the issue is presented by the Commission's exercise of its rule-making power in such a way as to call for a determination of the limits of the statutory authorization.

3. *The court below was right.*

A. In the absence of any authority in support of their position, petitioners fall back upon a general discussion of the purposes of the statute, with a number of sweeping conclusions as to its remedial objectives to protect investors.* If these sweeping generalizations were to be applied literally the Act would have to be construed as designed to protect investors from any wrong at the hands of "insiders", however remote the wrong from security manipulation or inducing purchases and sales.

The cogent opinion of the Court of Appeals furnishes the best answer to petitioners' contention as to statutory purposes. (See R. 73-75.) In connection with the purposes of the Rule and Statute, and of § 10(b) in particular

* It is interesting to note that petitioners, in their broad statements as to a Congressional purpose to reach breaches of fiduciary responsibilities by corporate fiduciaries, cite (see Petition, p. 9 n) H. R. Rep. No. 1383, 73d Cong., 2d Sess. That report, however, was to accompany H. R. 9323, a bill which did not contain the provision that became § 10(b), so that any such purposes must be related to other provisions, not to this one. See H. R. 9323, 73d Cong., 2d Sess. § 9; also H. R. Rep. No. 1838 (Conference Report) 73 Cong., 2d Sess. at pp. 32-33.

as designed to fill a gap as to fraudulent manipulative devices in the case of *purchase* of securities as well as sale, see SEC Releases No. 3230, March 21, 1942, and No. 3634, December 22, 1944, pertinent parts of which are set out in the appendix; Sen. Rep. No. 792, 73d Cong., 2d Sess. at pages 1-13, 16-18; compare § 10(b) of the Securities Exchange Act and Rule X-10B-5 with § 17(a) of the Securities Act (48 Stat. 84, 15 U. S. C. § 77q (a)) and § 15(c) of the Securities Exchange Act (49 Stat. 1377, 15 U. S. C. § 78 o (c)); see Note, 59 Harv. L. Rev. 769, 770 (1946), cf. *Fischman* v. *Raytheon Mfg. Co.*, 188 F. 2d 783, 787, n. 2 (2d Cir. 1951); Loss, *Securities Regulation* (1951), pp. 806-810. See also *Joseph* v. *Farnsworth Radio & Television Corp.*, 99 F. Supp. 701, 706 (S. D. N. Y. 1951), another case where the decision, like that of the court below in the present case, recognized limitations in the scope of the Rule.

B. Even if what the complaint alleges had amounted to a violation of Rule X-10B-5, it is clear that this was not the cause of damage to petitioners. Clearly whatever damage petitioners claim to have sustained was due either to the failure of the corporation and its officers and directors to consummate a merger with Follansbee Steel Corporation, or to the sale by controlling stockholder Feldmann of his 40% interest in the Newport Steel Corporation to Wilport Company. Except for general allegations of violations of the Rule which refer to matters "more fully set forth hereinafter" or "stated above" or "specified in the preceding paragraphs" (R. 6-7, 12, 13, 16, 17) and which must therefore be related to specific allegations in the remainder of the complaint, the only allegations in the complaint of acts involving use of the mails or other instrumentalities of interstate commerce in violation of Rule X-10B-5 are the allegations of the sending of three communications. The first was a letter from Feldmann telling of the breakoff of negotiations with Follansbee Steel Corporation after that break had taken place. (R. 9-10, 20-21.) The second and third communications were from the new officers of Newport and related to the sale by Feldmann of his stock to Wilport Company. (R. 13-14, 22-24,

26-27.) These also were communications sent after the events they discussed had already taken place. The first letter is claimed to have been false and misleading in that it failed to report a firm offer by Follansbee and Feldmann's personal interest in rejection of that offer. The second and third are alleged to have omitted to state the price paid for the Feldmann stock; and the second also to have omitted a statement of the purpose to make Newport a "captive subsidiary." (R. 9-10, 13-14.) It is not alleged that petitioners took or failed to take any action whatever in reliance on these communications or that they purchased or sold stock in consequence of what was said or omitted in the communications. Obviously the letters had nothing to do with bringing about Feldmann's rejection of one offer and his acceptance of the other out of which any damage to plaintiffs or their corporation arose.

Clearly, therefore, plaintiffs had no cause of action resulting from a violation of the Rule. Even if, *arguendo*, the communications alleged were a fraudulent scheme as that expression is used in Rule X-10B-5, or otherwise within its terms, and even though a breach of the Rule resulting in damage to an individual gives rise to a private cause of action in his favor, the most elastic concept of the scope and purpose of the Act and the Rule will hardly suffice for a construction giving a private cause of action for a breach of the Rule which did not cause any damage to the plaintiff.

Plaintiffs' contention would unjustifiably load upon the federal courts a large proportion of all derivative stockholder litigations.

WHEREFORE, it is urged that the petition be denied.

Respectfully submitted,

A. DONALD MACKINNON
Attorney for Respondent
Wilport Company

REBECCA M. CUTLER,
Of Counsel

May 15, 1952

Appendix

"For Immediate Release Thursday, May 21, 1942

Securities and Exchange Commission
Philadelphia

Securities Exchange Act of 1934
Release No. 3230

The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase. The text of the Commission's action follows: * * *."

"For Immediate Release Friday, December 22, 1944

Securities and Exchange Commission
Philadelphia

Securities Exchange Act of 1934
Release No. 3634

Securities Act of 1933
Release No. 3034

Since the adoption on May 21, 1942 of Rule X-10B-5 pursuant to Sections 10(b) and 23(a) of the Securities Exchange Act of 1934, the Commission has received numerous inquiries as to its extent and application. Generally speaking, this Rule embodies the broad anti-fraud provisions of Section 17(a) of the Securities Act of 1933 but specifically prohibits fraud not only in connection with the sale of securities but also in connection with the purchase of securities. * * *"